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REDUCING LOAN DEFAULT RATE AMONG MICROFINANCE INSTITUTIONS (MFIs) IN GHANA THROUGH INNOVATIVE PRODUCT DESIGN, DELIVERY AND EFFICIENT LOAN MANAGEMENT

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Abstract

Micro, Small and Medium Enterprises (MSMEs) have been identified as the catalyst for the economic growth of a country. They are a major source of income and employment and consequently poverty reduction. Small and Medium Enterprises (SMEs) contributed 49% of Ghana's GDP in 2012 which impact significantly on economic growth, income and employment. Traditionally, financial institutions have been cautious with lending to MSMEs due to the high default rates and risks associated with such ventures. Microfinance institutions, however, seemed to have the means to make financial services available to relatively poor households and microenterprises in transactions suited to their conditions. In spite of this, high default rates in MSMEs lending is a major concern to policy makers in developing countries, because of its unintended negative impacts on MSMEs financing. This paper therefore proposes a conceptual framework that reduces loan defaults in MSMEs lending among MFIs in Ghana via Innovative loan product design, delivery and efficient management. This paper concludes that, for MFIs to be sustainable and profitable, it is imperative on them to be innovative in their products design and services. It is recommended that MFIs commit resources to their human resource capacity building and market research to stay competitive.

Keywords: Loan Default Rate, Innovative Products Design, Microfinance, Loan Management

INTRODUCTION

Data from the Registrar General of Ghana indicates that 90% of firms registered are Micro Small and Medium Enterprises (MSMEs) (Mensah, 2004). Similarly, the Ministry of Trade and Industry, in 1998 estimated that the Ghanaian private sector (mainly dominated by MSMEs), consists of approximately 80,000 registered limited companies and 220,000 registered partnerships (Mensah, 2004). MSMEs have been identified as the catalyst for the economic growth of a country as they are a major source of income and employment and consequently poverty reduction (Beck, Demirguc-Kunt & Levine, 2003). Small and Medium Enterprises (SMEs) contributed 49% of Ghana's GDP in 2012 which impact significantly on economic growth, income and employment(Ghana Banking survey, 2013).Micro-entrepreneurs constitute about 66% of the labor force in Ghana and, thus, represent a vital economic force (Adjei, 2010). Small enterprises in Ghana are said to be a characteristic feature of the production landscape and have been noted to provide about 85% of manufacturing employment of Ghana (Steel and Webster, 1991; Aryeetey, 2001).

Notwithstanding these outstanding role MSMEs play in the development and sustainability of national economies, access to finance remained a dominant constraint to small scale enterprises both locally and internationally (Aryeetey et al 1994; Daniels and Ngwira, 1993). Traditionally, financial institutions have been cautious with lending to MSMEs due to the high default rates and risks associated with such ventures (Mensah, 2004;Quaye et al, 2014).Microfinance institutions, however, seemed to have the means to make financial services available to relatively poor households and microenterprises in small transactions suited to their conditions (Dzisi et al, 2013;Quaye et al,2014).Richard (2007) considers microfinance as a range of innovative financial arrangements designed to attract the poor either as borrowers or savers. According to Ghartey (2007), microfinance relates to the provision of financial services (i.e. savings, credit, insurance and remittances) to a larger number of the productive but resource poor, in a cost-effective and sustainable manner with the view to creating wealth and reducing poverty.

The introduction of microfinance into Ghana has made it possible for operators of small businesses to access credit facilities which hitherto were difficult to access due to difficult modalities by the formal financial institutions. Microfinance provides people with capital to start and or expand their businesses. Small businesses with microfinance support have grown into Medium Enterprises creating employment opportunities for others. Microfinance Institutions (MFIs) currently provide financial services to an estimated 15 per cent of the country's total population as compared with 10 per cent for the commercial banking sector (Obuobi and Polio, 2010). In view of this, the role of microfinance institutions in developing local economies cannot be over emphasized especially in developing countries like Ghana (Ntiamoah et al, 2014).However heartwarming the intervention of MFIs may be, the incidence of high loan default rate among MSME lending seems to be undermining the continuous financing of MSMEs by MFIs in Ghana. The issue of loan delinquency/default among banks and Microfinance Institutions has been discussed in many public lectures and fora as one of the reasons why commercial banks have not shown much interest in financing MSMEs (Addae-Korankye, 2014). According to Balogun and Alimi (1990), loan default is the inability of a borrower to fulfil his or her loan obligation when due. As observed by Addae-Korankye (2014), high default rates in MSMEs lending is a major concern to policy makers in developing countries, because of its unintended negative impacts on MSMEs financing. Microfinance institutions all over the world including Ghana are faced with the challenge of loan default/delinquency.

According to Warue (2012), the most common and often the most serious vulnerability in a microfinance institution is the chance that a microfinance institution (MFI) may not receive its money back from borrowers (plus interest). The sustainability of microfinance institutions depends largely on their ability to collect their loans as efficiently and effectively as possible. In other words to be financially viable or sustainable, microfinance institutions must ensure high portfolio quality based on 100% repayment, or at worst low delinquency/default, cost recovery and efficient lending (Addae-Korankye, 2014). Addae-Korankye (2014) further reports in a study in Ghana involving 25 MFIs that, 60% of the MFIs have their default rates more than the internationally acceptable rate of 3%. This situation poses serious threats to the operations and sustainability of these MFIs which are the financial backbone of Micro, Small and Medium Enterprises in Ghana.

It is against this backdrop that this study considers an innovative approach in curtailing the default rate phenomenon among MSMEs. The remainder of this paper is structured as follows: Sections 2 and 3 cover the objective of the study and the literature review respectively. The conceptual framework and discussion of the study is presented under sections 4 and 5 respectively whiles section 6 presents the conclusion and recommendations of the study.

Objective of the study

The objective of this study is to develop a conceptual framework based on product design and delivery as well as effective loan management system to reduce MSMEs lending defaults rates among MFIs in Ghana. This concept will among other things ensure that loan products meet the needs of the diverse MFI clientele in Ghana and that loan proceeds are invested directly into the entrepreneur’s business. This will among other things assist entrepreneurs to overcome self-control problems or the diversion of cash into non-business activities while promising positive cash flow for on-time repayment of loans.

LITERATURE REVIEW

Definition of delinquency/default

Many scholars have given several but converging definitions of loan delinquency and default. CGAP (1999), describes a loan as delinquent when a payment is late. A delinquent loan becomes a defaulted loan when the chance of recovery becomes minimal (Addae-Korankye, 2014). In the view of Ameyaw-Amankwah (2011), default occurs when a debtor has not met his or her legal obligations according to the debt contract. According to Murray (2011), a loan default occurs when the borrower does not make required payments or in some other way does not comply with the terms of a loan. Balogun and Alimi (1990) also define loan default as the inability of a borrower to fulfil his or her loan obligation as at when he or she falls due.

Causes of loan defaults

A number of reasons have been cited as the causes of loan delinquency or default. These include lack of willingness to pay loans, diversion of funds by borrowers, willful negligence, and improper appraisal by credit officers. Also included are exchange rate depreciation, loan shortages, delay in time of loan delivery, small farm size, high interest rate, age of farmers, poor supervision, non-profitability of farm enterprises and undue government intervention with the operations of government sponsored credit programmes [Ahmad, (1997);Balogun and Alimi (1990); Akinwumi and Ajayi (1990); Olomola (2001); Vandel (1993) and Kwakwa, (2009)]. Other studies have also identified improper selection of an entrepreneur, deficient analysis of project viability, inadequacy of collateral security/equitable mortgage against loans, unrealistic terms and schedule of repayment, lack of follow up measures, natural calamities, the nature, and time of disbursement to be the cause of high default rates among MSMEs. [Berger and De Young (1997), Okorie (1986)]. Poor management of loans processes by MFIs has also been cited as one of the causes of loan default/delinquency [(Kohansal and Mansoori (2009), Warue (2012)].

Measures to reduce loan defaults among MFIs

A number of authors are of the view that proper and adequate appraisal is key to controlling or minimizing default [Sheila (2011);Anjichi (1994), Hunte (1996),Addae-Korankye, (2014)].Due diligence during the monitoring and control stage in the lending process is also cited as an effective way of reducing defaults [Sheila (2011), Anjichi (1994), Saywer (1998)]Several studies have been performed on the group lending aspect of microfinance, and most research shows it to be an effective method, [(Wenner (1995), (Woolcock (2001), Goldmark (2001), Van Tassel (1999), Ghatak (1999), Islam (1995)].

CONCEPTUAL FRAMEWORK

Product Design

Waterfield (2001) indicates that the proper design of financial products and their respective delivery methodologies is fundamental to an institution's effective and sustainable delivery of financial services. He further noted that credit institutions need to incorporate financial products and delivery methodologies which are both appropriate for the specific needs of the target group and sustainable. Financial products also need to be sustainable from the institution's point of view in order for the target group to continue having access to these financial products in the long term. Waterfield (2001) again indicates that Micro and Small Enterprise financial products deviate radically from those employed by formal lending institutions, particularly those products directed at microenterprises.

Brau and Woller (2004) argues that MFIs provide similar products and services to their customers as formal sector financial institutions except for the scale and method of delivery. Nourse (2001) reviews the context and rise of microfinance products and agrees that MFIs need to provide tailored lending services for the poor instead of rigid loan products. Supporting this latter assertion of Nourse (2001), Eyiah (2001) develops a model of small construction management contractors and MFIs in developing countries that provides a tailored lending structure for microenterprise contractors. Similarly, Woller (2002a), Cohen (2000), and Dunn (2002) argue that MFIs need to be more client-focused, including offering a mix of financial products tailored to the varied needs and wants of poor consumers. Bhatt and Tang (2001c) discuss MFI vehicles, technologies, and performance assessments and conclude that the future success of microfinance will depend on MFI design tailored to specific clients.

This paper strongly agrees with Waterfield (2001) and the other authors, stressing on two things: (1) proper design of financial products and (2) effective delivery method. These two (product design and delivery) when managed efficiently and effectively will help to reduce some of the known causes of default including (i) External pressures to divert the money (e.g., for medical emergencies, school fees, family maintenance); (ii) behavioral 'biases' in decision-making (e.g., present biasedness, lack of self-control); and (iii) the nature of the investment required (e.g., its lumpiness) (Camerer and Loewenstein 2003; Mullainathan 2002; Rabin 2002).

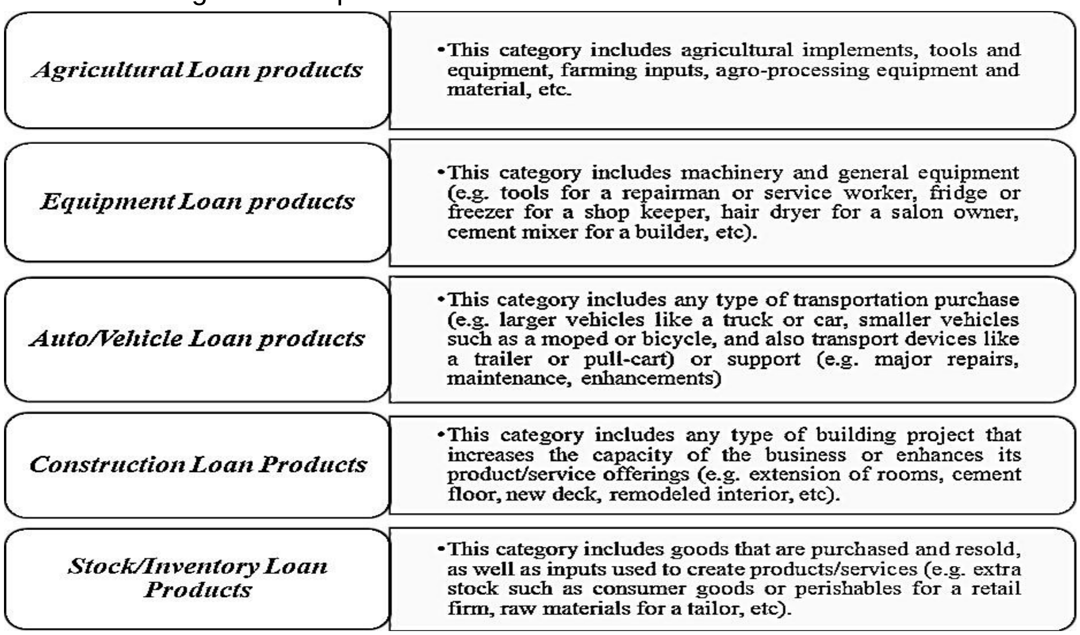
Loan Management

Bichanger and Aseya (2013) reports that inadequate or non-monitoring of micro and small enterprises by banks, delays by banks in processing and disbursement of loans, diversion of funds, over-concentration of decision making, where all loans are required by some banks to be sanctioned by Area/Head Offices are some of the causes of loan defaults. Sheila (2011) also cites inadequate financial analysis as another cause of loan default. Warue (2012) from a study conducted in Kenya, cited management failure by MFIs and Self Help Groups' (SHGs') as a cause of default. He stressed that for effective management of delinquency/default, it is critical for MFIs to understand and focus more on the internal causes of delinquency which they have more control over. Kohansal and Mansoori (2009) equally agree with Warue (2012) when they said Most of the defaults arose from poor management procedures, loan diversion and unwillingness to repay loans. This paper therefore proposes two innovative solutions to reduce business loan defaults among MFIs in Ghana :(1) Innovative product design and delivery (2) Effective loan management model.

Reducing Defaults through Innovative Product Design and Delivery

Based on the observations of Nourse (2001), Eyiah (2001), Woller (2002a), Cohen (2000), Bhatt and Tang (2001c) and Dunn (2002) arguing that MFIs need to be more client-focused, including offering a mix of financial products tailored to the varied needs and wants of poor consumers, this paper creates five (5) business loan products which in the view of this paper will serve the needs of the MFI clientele in Ghana.

Figure 1: Proposed Innovative Loan Products for MSMEs



Source: Authors' construct

The proposed product design is also largely based on the categorization of the informal sector in Ghana according to Adu-Amankwah (1999); Osei-Boateng and Apratwum (2011) and Adu-Amankwah (2011). These authors categorize the informal sector of Ghana into two (2): (1) the rural informal sector which is largely Agricultural and related activities; and (2) urban informal sector which comprises (i) Services (Urban food traders and processors, health and sanitation workers, Domestic workers, repairers of watches, refrigeration equipment, radios, mechanical or electrical/electronic equipment, garages, graphic designers, audio-visual workers, hairdressers and barbers/private security men);(ii) Construction (Construction workers - made up of masons, carpenters, steel benders, small-scale plumbers, house-wiring electricians, and carpenters;(iii) Manufacturing (food processing, textile and garments, wood processing and metal works).The delivery of the product is as important as the product itself. This paper therefore adopts innovative delivery process comprising not just the basic terms, conditions and price as is often thought, but all "8Ps" of marketing as depicted in figure 2.

Figure 2: Proposed Innovative Product Delivery Process

The "P"	•DETAILS OF THE "P"
Product (design)	•Includes specific product features, opening/minimum savings balances, liquidity/withdrawal terms, loan terms, ancillary services such as loan review and disbursement times, collateral or guarantees, amortization schedules, repayment structures (e.g. balloon payments or interest-free grace periods etc).
Price	•Includes the interest rate, withdrawals costs, statement/ledger fees, loan fees, prepayment penalties, prompt payment incentives, transaction costs and other discounts
Promotion	•Includes advertising, public relations, direct marketing, publicity, and all aspects of sales communication.
Place	•This category includes goods that are purchased and resold, as well as inputs used to create products/services (e.g. extra stock such as consumer goods or perishables for a retail firm, raw materials for a tailor, etc).
Positioning	•Is the effort by the microfinance institutions (MFI) to occupy a distinct competitive position in the mind of the target customer. This could be in terms of low transaction cost, low price, high quality, security of savings, quick turnaround time, professional service, etc. It is a perception
Physical Evidence	•Includes the presentation of the product: how the branch physically looks, whether it is tidy or dirty, newly painted or decaying, the appearance of the brochures, posters and passbooks etc.
People	•Includes how the clients are treated by the people involved with delivering the product – in other words the staff of the MFI. It also includes recruitment, internalcommunications, performance monitoring and training. To get the best performance from staff, MFIs need to recruit the right staff then invest in training on customer service and in products, the MFIs' processes and procedures.
Process	•Includes the way or system in which or through the product is delivered: how the transaction is processed and documented, the queues/waiting involved, the forms to be filled etc.

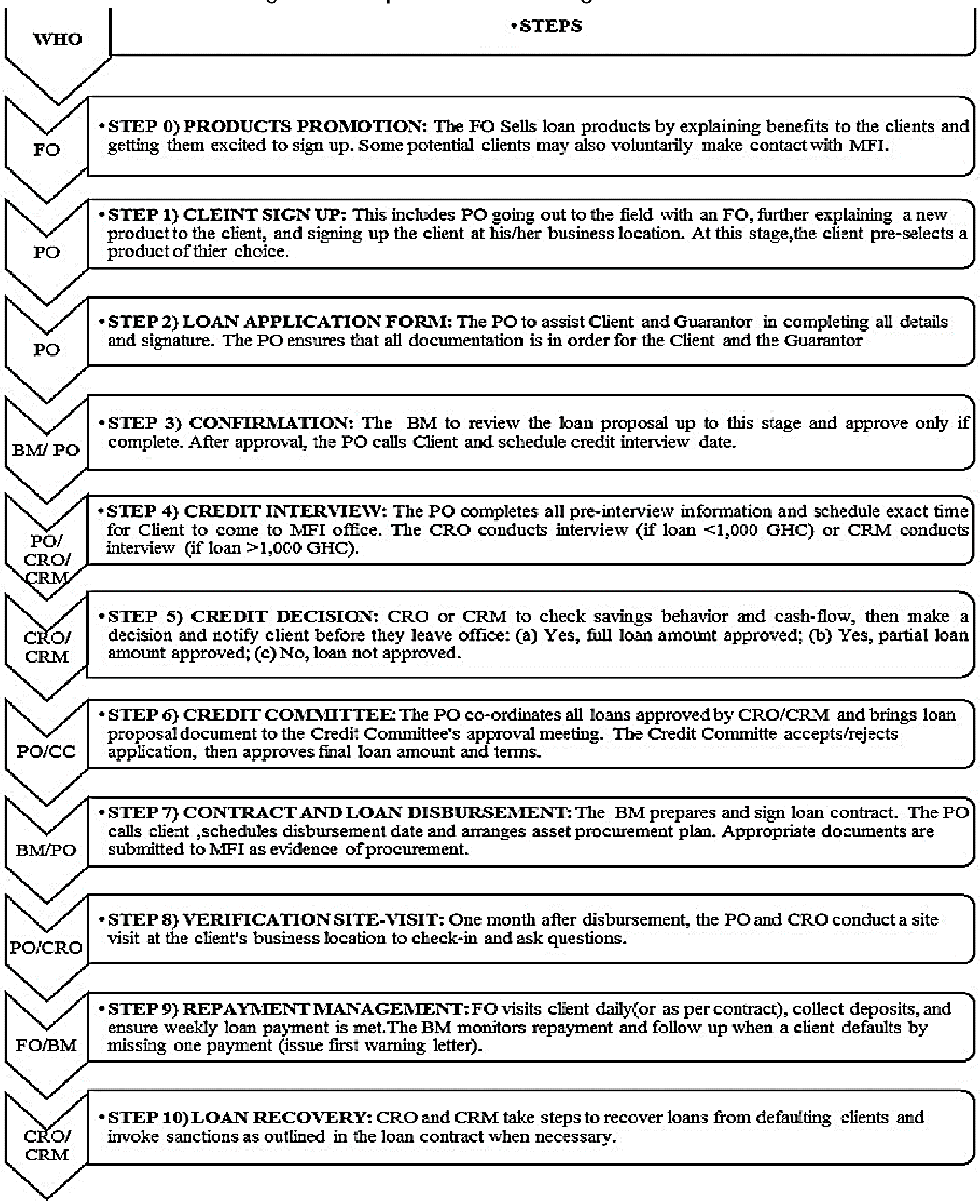
Source: Wright (2005)

The products, delivery processes and channels outlined above highlight the revolution underway in microfinance. As different financial institutions become increasingly interested and involved in the low-income segment of the market, so the products and options for delivering them are expanding rapidly. The days of an inflexible working capital loan as the only product available to the poor customer are over as microfinance moves onto a market-led basis. Market-led microfinance puts the customer at the center of the business. In the context of product development, this means understanding the customer and his/her needs in order to develop client-responsive, flexible financial services (Wright, 2005).

Reducing Defaults through Efficient Loan Management Model

This paper presents a loan management model that ensures that loan funds are invested directly in productive business assets thereby minimizing if not avoiding diversion and default. In all, there are ten simplified steps (See figure 3).

Figure 3: Proposed Loan Management Model



Source: Authors' Construct

Explanation of the model

In this model, the MFI assists the client to purchase the pre-specified firm assets (categorized under any of the five proposed products) during disbursement. The client pre-selects the product and category during sign-up. It must be noted that these processes are managed by Field officer (FO), Product Officer (PO) who also double as the team leader for at most five (5) FOs, Branch Manager (BM), Credit Recovery Officer (CRO) and the Credit Recovery Manager (CRM) who manages the CROs.

Products Promotion and Client Sign up

Field officers (FOs) will market the new products during their daily visits to the entrepreneur's business location through printed brochures and in their personal sales interactions. The FOs sell the loan products by explaining benefits to the client and getting the client excited to sign up. This approach is proactive and complementary to the traditional way of marketing that many MFIs in Ghana operate where loan applicants rather make first contact with the institution. The PO also follows up on the field with the FO, further explaining the products to the client, and signing up the client at his/her business location. The client pre-selects a product of his/her choice from the five (5) categories of products proposed during sign up.The PO at this stage collect preliminary information about client and their business including location information (a description and or GPS coordinates).

Loan Appraisal

The PO assists the Client and the Guarantor(s) in completing all details and signature. When the PO has verified that all documentation is in order for the Client and the Guarantor, a visit to the applicant's household is arranged. The information thus developed is organized into a formal loan proposal. The loan document is further verified by the BM.

Credit Interview/Approval

At this stage, the PO completes all pre-interview information and schedule exact time for Client to come to MFI's office for an interview. The interview is conducted by the CRO or the CRM. The loan amount and tenure are confirmed conditional on the adequacy of the cash flows generated by the borrower's business, sufficient personal collateral(for some MFIs in Ghana, a savings cash collateral of between 20% to 30% of loan amount is required) and guarantors agreeing to co-sign the loan agreement. The CRO/CRM make a decision on the loan amount and tenure and inform the client before he/she leaves the office. The decision may be (a) Yes, full loan amount approved; (b) Yes, partial loan amount approved; (c) No, loan not approved.

The PO then co-ordinates all loans approved by CRO/CRM and present them to the credit committee (CC) for final approval. The Credit Committee either accepts or rejects the application, then approves final loan amount and terms if accepted.

Contract and Loan Disbursement

BM prepares and signs loan contract with client. The PO calls the client and schedule disbursement date and time as well as arranges the assets procurement with the client. The PO accompanies the client to purchase the pre-selected asset and deliver it to the client's business location. Photographs and or receipts are presented to the MFI for documentation as evidence of the transaction.

Post loan disbursement

FO also visit client daily, collect deposits, and ensure weekly loan payment is met. One month after disbursement, the PO and CRO conducts a site visit at the client's business location to check-in and interact with the client. CRO/CRM monitors repayment and follow up when a client misses payment. CRO and CRM take steps to recover loans from defaulting clients and invoke sanctions as outlined in the loan contract.

DISCUSSION

Strengths of the proposed model

The premise of this model: innovative product design and efficient loan management model is that by offering a mix of financial products tailored to the varied needs and wants of poor consumers coupled with efficient supervision and or control of the loan process, a lot of the major causes of default among these entrepreneurs are eliminated. This concept among other things ensures that loan products meet the needs of the diverse MFI clientele in Ghana and that loan proceeds are invested directly into the entrepreneurs business. This will among other things assist entrepreneurs to overcome self-control problems or the diversion of cash into non-business activities whiles promising positive cash flow for on-time repayment of loans. Again, the proposed loan products model identifies with the needs of MSMEs and makes it easy for clients to know specifically what they want at sign up and pre-select a product that best suits their interest. The categorization of the products also helps MFIs to build capacity and understanding in several sectors of their market at the same time. This also helps them to be more efficient and competitive in their operation.

This proposed management model exercises control over the disbursement and thereby ensures that the loan funds are invested directly into the business which leads to increase in productivity and generating funds to repay debt. Quite often when these business owners do obtain loans for investment, the internal, external and business pressures they face are such that they too often divert the loan capital to other purposes. This diversion implies that the business owners not only fail to increase productivity by investing in new assets, but they also often fall into a spiral of debt. The process involved in disbursing the business loans is similar to that used by de Mel, McKenzie and Woodruff (2009) and Fafchamps et al. (2011) when disbursing in-kind grants in Sri Lanka and Ghana. In some instances, the client is never given the loan proceeds in cash, only the productive asset. The proposed model also ensures efficient communication, continuity and speedy processing of loans. The process is largely coordinated by the Product Officer from sign up to post disbursement. This builds up client confidence and trust in MFI resulting in loyalty and honoring loan contracts. The model allows each stage of the process to be verified by another person thereby ensuring proper and adequate appraisal which according to Sheila (2011); Anjichi (1994); Hunte (1996); and Addae-Korankye (2014) is key to controlling or minimizing default.

Weaknesses of the proposed model

The loan disbursement stage is one most critical part of this model. Firstly, it may require careful planning and extra logistics. Again, there are limitations on the kind of products or assets that the MFIs can facilitate their purchase. The MFIs may not also have the needed capacity in terms of human resources and financial resources to manage the assets procurement. Again, this model may not be a one-fit-for-all. Different organizations that want to adopt it will have to adjust the processes to suit their needs.

CONCLUSION

A number of reasons have been cited by different scholars as the causes of high loan defaults rates among MSMEs lending by MFIs. Many of these causes result from the MFIs inability to control and manage their own operations. There are also factors that relate to the loan benefactor such as external pressures to divert the money (e.g., for medical emergencies, school fees, family maintenance), behavioral 'biases' in decision-making (e.g., present biasedness, lack of self-control) and the nature of the investment required (e.g., its lumpiness) MFIs in Ghana can reduce loan defaults in MSMEs by designing financial products that inherently reduce the risk of default by patrons. MFIs need to be more client-focused, including offering a mix of financial products tailored to the varied needs and wants of poor consumers. Again, MFIs can reduce non-performing loans through sound management practice and effective supervision.

RECOMMENDATIONS

This study is of the view that, for MFIs to be sustainable and profitable, it is imperative on them to be innovative in their products design and unique in the services they render. It is therefore recommended that MFIs assign resources to research to understand the demands of their market. It is also recommended that MFIs build the capacity of their personnel to enable them exercise sound management practices and MFI design.

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